

**REVISION OF MULTISTATE TAX COMMISSION ALLOCATION AND
APPORTIONMENT REGULATION IV.1(b) SETTING FORTH PRINCIPLES FOR
DETERMINING THE EXISTENCE OF A UNITARY BUSINESS**

**Approved by the Multistate Tax Commission
January 15, 2004**

•• Reg. IV.1.(b). Principles for Determining the Existence of a Unitary Business.

(1) Unitary Business Principle.

(A) *The Concept of a Unitary Business.* A unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. This flow of value to a business entity located in this state that comes from being part of a unitary business conducted both within and without this State is what provides the constitutional due process "definite link and minimum connection" necessary for this state to apportion business income of the unitary business, even if that income arises in part from activities conducted outside the state. The business income of the unitary business is then apportioned to this state using an apportionment percentage provided by [insert your state statute].

This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contributes to the activities of another business *or* are dependent upon the activities of another business, those businesses are part of a unitary business.

(B) *Constitutional Requirement for a Unitary Business.* The sharing or exchange of value described in subsection (A) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no *operational* relationship to the unitary business.

In this State, the unitary business principle shall be applied to the fullest extent allowed by the U.S. Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of such activities or entities would not be allowed by the U.S. Constitution.

(C) *Separate Trades or Businesses Conducted within a Single Entity.* A single entity may have more than one unitary business. In such cases it is necessary to determine the business, or apportionable, income attributable to each separate unitary business as well

as its nonbusiness income, which is specifically allocated. The business income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

(D) *Unitary Business Unaffected by Formal Business Organization.* A unitary business may exist within a single business entity or among a commonly controlled group of business entities. The scope of what is included in a commonly controlled group of business entities is set forth in Section V below.

(2) Determination of a Unitary Business

(A) A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. [RESERVED: See regulation concerning passive holding companies for special rules that govern the determination of whether a pure or passive holding company constitutes a part of a unitary business with one or more affiliates conducting active business operations.] Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation. A particular business operation may be suggestive of one or more of the factors mentioned above.

(B) *Description and Illustration of Functional Integration, Centralization of Management and Economies of Scale.*

1. *Functional integration:* Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration includes, but is not limited to, transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that can support the finding of functional integration. The order of the list does not establish a hierarchy of importance.
 - a. Sales, exchanges, or transfers (collectively "sales") of products, services, and/or intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and/or the percentage of total sales or purchases represented by the intercompany sales. For example, sales among business entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to effect the intercompany sales,

because such sales can represent an assured market for the seller or an assured source of supply for the purchaser.

- b. *Common Marketing.* The sharing of common marketing features among business entities is an indication of functional integration when such marketing results in significant mutual advantage. Common marketing exists when a substantial portion of the business entities' products, services, or intangibles are distributed or sold to a common customer, when the business entities use a common trade name or other common identification, or when the business entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. (Such activity, however, is relevant to determining the existence of economies of scale and/or centralization of management.)
 - c. *Transfer or Pooling of Technical Information or Intellectual Property.* Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development, provide evidence of functional integration when the matter transferred is significant to the businesses' operations.
 - d. *Common Distribution System.* Use of a common distribution system by the business entities, under which inventory control and accounting, storage, trafficking, and/or transportation are controlled through a common network provides evidence of functional integration.
 - e. *Common Purchasing.* Common purchasing of substantial quantities of products, services, or intangibles from the same source by the business entities, particularly where the purchasing results in significant cost savings or where the products, services or intangibles are not readily available from other sources and are significant to each entity's operations or sales, provides evidence of functional integration.
 - f. *Common or Intercompany Financing.* Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business entities for the benefit of another business entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending which serves an investment purpose of the lender does not necessarily provide evidence of functional integration. (See below for discussion of centralization of management.)
2. *Centralization of Management.* Centralization of management exists when directors, officers, and/or other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from

a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single business entity to another division within a business entity, or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role can be effected through mandates, consensus building, or an overall operational strategy of the business, or any other mechanism that establishes joint management.

- a. *Facts Providing Evidence of Centralization of Management.* Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are common directors.
 - b. *Stewardship Distinguished.* Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.
3. *Economies of Scale.* Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that can support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.
- a. *Centralized Purchasing.* Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.
 - b. *Centralized Administrative Functions.* The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit administration, in common among the parts of the business may result in some degree of economies of scale. A business entity that secures savings in the performance of corporate administrative services due to its

affiliation with other business entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market, provides evidence of economies of scale.

(3) Indicators of a Unitary Business.

- (A) *Same Type of Business.* Business activities that are in the same general line of business generally constitute a single unitary business, as, for example, a multistate grocery chain.
- (B) *Steps in a Vertical Process.* Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.
- (C) *Strong Centralized Management.* Business activities which might otherwise be considered as part of more than one unitary business may constitute one unitary business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Strong centralized management exists when a central manager or group of managers makes substantially all of the operational decisions of the business. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices which perform for the business activities the normal matters which a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

(4) Commonly Controlled Group of Business Entities.

- (A) Separate corporations can be part of a unitary business only if they are members of a commonly controlled group.
- (B) A "commonly controlled group" means any of the following:
 - 1. A parent corporation and any one or more corporations or chains of corporations, connected through stock ownership (or constructive ownership) with the parent, but only if--
 - a. The parent owns stock possessing more than 50 percent of the voting power of at least one corporation, and, if applicable,
 - b. Stock cumulatively possessing more than 50 percent of the voting power of each of the corporations, except the parent, is owned by the parent, one or more

corporations described in subparagraph a, or one or more other corporations that satisfy the conditions of this subparagraph.

2. Any two or more corporations, if stock possessing more than 50 percent of the voting power of the corporations is owned, or constructively owned, by the same person.
 3. Any two or more corporations that constitute stapled entities.
 - a. For purposes of this paragraph, "stapled entities" means any group of two or more corporations if more than 50 percent of the ownership or beneficial ownership of the stock possessing voting power in each corporation consists of stapled interests.
 - b. Two or more interests are stapled interests if, by reason of form of ownership, restrictions on transfer, or other terms or conditions, in connection with the transfer of one of the interests the other interest or interests are also transferred or required to be transferred.
 4. Any two or more corporations, if stock possessing more than 50 percent of the voting power of the corporations is cumulatively owned (without regard to the constructive ownership rules of paragraph 1 of subsection (E) by, or for the benefit of, members of the same family. Members of the same family are limited to an individual, his or her spouse, parents, brothers or sisters, grandparents, children and grandchildren, and their respective spouses.
- (C) 1. If, in the application of subsection (B), a corporation is a member of more than one commonly controlled group of corporations, the corporation shall elect to be treated as a member of only the commonly controlled group (or part thereof) with respect to which it has a unitary business relationship. If the corporation has a unitary business relationship with more than one of those groups, it shall elect to be treated as a member of only one of the commonly controlled groups with respect to which it has a unitary business relationship. This election shall remain in effect until the unitary business relationship between the corporation and the rest of the members of its elected commonly controlled group is discontinued, or unless revoked with the approval of the [state tax agency].
2. Membership in a commonly controlled group shall be treated as terminated in any year, or fraction thereof, in which the conditions of subsection (B) are not met, except as follows:
 - a. When stock of a corporation is sold, exchanged, or otherwise disposed of, the membership of a corporation in a commonly controlled group shall not be terminated, if the requirements of subsection (B) are again met immediately after the sale, exchange, or disposition.

- b. The [state tax agency] may treat the commonly controlled group as remaining in place if the conditions of subsection B are again met within a period not to exceed two years.
- (D) A taxpayer may exclude some or all corporations included in a "commonly controlled group" by reason of paragraph 4 of subsection (B) by showing that those members of the group are not controlled directly or indirectly by the same interests, within the meaning of the same phrase in Section 482 of the Internal Revenue Code. For purposes of this subsection, the term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised.
- (E) Except as otherwise provided, stock is "owned" when title to the stock is directly held or if the stock is constructively owned.
 - 1. An individual constructively owns stock that is owned by any of the following:
 - a. His or her spouse.
 - b. Children, including adopted children, of that individual or the individual's spouse, who have not attained the age of 21 years.
 - c. An estate or trust, of which the individual is an executor, trustee, or grantor, to the extent that the estate or trust is for the benefit of that individual's spouse or children.
 - 2. Stock owned by a corporation, or a member of a controlled group of which the corporation is the parent corporation, is constructively owned by any shareholder owning stock that represents more than 50 percent of the voting power of the corporation.
 - 3. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), if more than 50% of the stock possessing voting power of a corporation is, in the aggregate, owned by or for the benefit of members of the same family, stock owned by that corporation shall be treated as constructively owned by members of that family in the same ratio as the proportion of their respective ownership of stock possessing voting power in that corporation to all of such stock of that corporation.
 - 4. Except as otherwise provided, stock owned by a partnership is constructively owned by any partner, other than a limited partner, in proportion to the partner's capital interest in the partnership. For this purpose, a partnership is treated as owning proportionately the stock owned by any other partnership in which it has a tiered interest, other than as a limited partner.
 - 5. In any case where a member of a commonly controlled group, or shareholders, officers, directors, or employees of a member of a commonly controlled group, is a

general partner in a limited partnership, stock held by the limited partnership is constructively owned by a limited partner to the extent of its capital interest in the limited partnership.

6. In the application of paragraph 4 of subsection (B) (dealing with stock possessing voting power held by members of the same family), stock held by a limited partnership is constructively owned by a limited partner to the extent of the limited partner's capital interest in the limited partnership.

(F) For purposes of the definition of a commonly controlled group, each of the following shall apply:

1. "Corporation" means a subchapter S corporation, any other incorporated entity, or any entity defined or treated as a corporation (including but not limited to a limited liability company) pursuant to [insert your State statute].
2. "Person" means an individual, a trust, an estate, a qualified employee benefit plan, a limited partnership, or a corporation.
3. "Voting power" means the power of all classes of stock entitled to vote that possess the power to elect the membership of the board of directors of the corporation.
4. "More than 50 percent of the voting power" means voting power sufficient to elect a majority of the membership of the board of directors of the corporation.
5. "Stock possessing voting power" includes stock where ownership is retained but the actual voting power is transferred in either of the following manners:
 - a. For one year or less.
 - b. By proxy, voting trust, written shareholder agreement, or by similar device, where the transfer is revocable by the transferor.
6. In the case of an entity treated as a corporation under paragraph 1 of subsection (F), "stock possessing voting power" refers to an instrument, contract, or similar document demonstrating an ownership interest in that entity that confers power in the owner to cast a vote in the selection of the management of that entity.
7. In the general application of this section, if an entity may elect to be treated as a partnership or as a corporation under the laws of this state (or under Section 7701 of the Internal Revenue Code), and elects to be treated as a partnership, that entity shall be treated as a general partnership. If, however, contractual agreements, member agreements, or other restrictions limit the power of some or all of the members to participate in the vote of stock possessing voting power owned by that entity (similar to the restrictions of limited partners in a limited partnership), the [state tax agency] may permit or require that entity to be treated as a limited partnership.

(G)The [state tax agency] may prescribe any regulations as may be necessary or appropriate to carry out the purposes of this section, including, but not limited to, regulations that do the following:

1. Prescribe terms and conditions relating to the election described by subsection (C), and the revocation thereof.
2. Disregard transfers of voting power not described by paragraph 5 of subsection (F).
3. Treat entities not described by paragraph 2 of subsection (F) as a person.
4. Treat warrants, obligations convertible into stock, options to acquire or sell stock, and similar instruments as stock.
5. Treat holders of a beneficial interest in, or executor or trustee powers over, stock held by an estate or trust as constructively owned by the holder.
6. Prescribe rules relating to the treatment of partnership agreements which authorize a particular partner or partners to exercise voting power of stock held by the partnership.
7. Treat limited partners as constructive owners of stock possessing voting power held by the limited partnership, in proportion to their interest in the partnership.